The Fundamentals, Functions, and Ethics of Litigation Finance

Claimholders and law firms in New York and across the country are using funding to achieve their legal and business goals. Here's how it works.

By David J. Kerstein and William C. Marra

You've probably received the call more times than you can remember. "I have a great case," a prospective client tells you, "but I can't pay your legal fees. Is there anything you can do?"

You could take the case on a contingency, litigating "for free" or at a discount in exchange for a share of case proceeds. But that's hard for most lawyers to do. You need money to pay your team and your rent while the litigation drags on. And maybe your CFO just won't allow you to do it because it's not your firm's business model to take that much risk. Restrictions on lawyers' access to third-party investor money make it very difficult for you to raise outside capital. And if you lose the case, you might be left with nothing.

For generations, this state of affairs left a lot of people with strong legal claims stuck outside the courthouse gates or forced to make do with the litigation strategy they can afford, not the litigation strategy they need. Many strong claims were never brought or were settled for a fraction of their actual value. At best, a claimholder had to settle for third-choice counsel, litigating on a shoestring, often against a well-capitalized defendant.

Over the past 15 years, litigation financing has emerged as a compelling solution to this old problem. Litigation finance allows a third-party investor—the funder—to bear some or all of the cost (and risk) of litigation, in exchange for a share of case proceeds. Claimholders who yesterday might have been forced to abandon their meritorious claims can now pursue them with their top-choice counsel.

And litigation finance has quickly grown into much more. Originally conceived as helping David battle Goliath, funding is now increasingly used by Goliath himself. Well-capitalized companies are using litigation finance to manage legal risk, monetize legal claims, reduce their litigation budgets, and share the risks and rewards of litigation the same way they use equity or debt financing to manage risk in their core business.

In this article, we'll give a brief overview of commercial litigation finance. We'll talk about the various types of funding offered by commercial litigation funders, and we'll explain why law firms and claimholders use funding. We'll then discuss a few ethical and regulatory issues related to funding, with an emphasis on a recent New York City Bar working group's conclusions about two of those issues: whether funding agreements between a funder and *law firm* (as opposed to between funder and claimholder) violate an ethics rule prohibition against "fee sharing" between lawyers and non-lawyers, and whether funding agreements and communications should be disclosed during litigation.

What Is Litigation Finance?

A litigation finance transaction is one where a legal claim is used to secure financing from a third party. Typically a third-party funder provides capital to a claimholder or law firm in exchange for an interest in the expected proceeds from a litigation matter. The core insight of litigation finance is that a legal claim is an asset just the same as any other asset, and that claimants and law firms should be able to secure financing against that asset the same way they can securing financing against any other asset.

Most commonly, the funder's return is "non-recourse" to the claimholder or law firm's other assets, which means that the funder's return is backed *only* by the case proceeds. If the case fails, the funder gets nothing. This feature makes litigation finance a particularly attractive alternative to traditional "recourse" funding, where the bank comes calling for your debt even if the case fails.

Who Are Litigation Funders?

Litigation funders come in many different stripes. Some funders are focused solely on litigation finance. Their investment teams primarily comprise litigation attorneys who vet matters for their strength, but who also provide the claimholder and counsel with strategic

David J. Kerstein is the Chief Risk Officer and Senior Investment Manager of Validity Finance. A former litigator at Gibson Dunn & Crutcher, Kerstein has six years of litigation experience and 15 years of commercial litigation experience. He can be reached at dave@validity-finance.com.

William C. Marra is Portfolio Counsel at Validity Finance. A former law clerk to Justice Samuel A. Alito, Jr., of the United States Supreme Court, Marra previously litigated commercial and constitutional cases at Cooper & Kirk, PLLC before joining Validity. He can be reached at will@validity-finance.com.

advice and an additional set of minds thinking about the best path to victory. Other funders, such as some hedge funds or family offices, invest in litigation matters as part of a broader portfolio of investments.

Funders tend to focus on either the commercial or consumer markets. Commercial litigation funders typically invest primarily in litigation or arbitration involving business disputes, such as actions involving breach of contract, breach of fiduciary duty, antitrust law, and the full range of intellectual property matters. Commercial litigation funders also usually invest across the major international arbitration institutions. Consumer litigation funders tend to invest in smaller-dollar transactions with claimholders or law firms in personal injury, medical malpractice, and mass tort matters.

We'll focus here on the commercial litigation finance market, though much of our analysis applies equally to the consumer funding market.

Plain Vanilla Single-Case Funding

The most common form of litigation funding is "fees and costs" funding for a single case. A litigation finance company pays some or all of the litigation fees and other costs of bringing suit, in exchange for a share of case proceeds. The litigation funder's contract is typically with the claimholder (as opposed to the law firm), with the funder essentially paying the fees and costs on behalf of the claimant.

Fees-and-costs funding is often structured so that all three stakeholders—the claimant, the law firm, and the funder—have some "skin in the game," or some money invested in the case. For example, a funder may agree to pay 50% of the legal fees, with the law firm investing the remaining 50% in exchange for a contingency fee interest in the case proceeds. This model turns the arrangement into a "hybrid" for the law firm (thus mitigating the firm's risk as compared to a full contingency arrangement), but a "full contingency" on the fees for the client's purposes (since the client is not paying any portion of the legal fees). Similarly, a funder may pay 50% of the costs of the litigation, with the claimholder responsible for the other 50% of the costs.

Funders can invest at any stage of a case. This point is especially salient in light of the current economic climate. Some clients seek funding at the outset of a case. Yet funders often see cases "midstream," where the claimant has been paying its lawyer by the hour but then runs out of money, or perhaps where the claimant needs an extra burst of support as trial approaches. Funders can convert an hourly case into a matter backed by litigation funding, and they can also convert a law firm's "full contingency" matter into a hybrid matter if the law firm is looking to share risk.

We noted earlier that the key insight of litigation finance is that a legal claim is an asset. Just as claimholders can use their legal claim as an asset to secure funding to finance the fees and costs they need to convert their legal claim into a final money judgment, so too may they use the legal claim to secure "working capital" or "operating capital" that can be used for general firm purposes. A funder can give the claimholder some amount of money—say, $1 million in cash at closing—secured against the case proceeds.

Appeals Funding and Asset Monetization

Every lawyer knows that just because you get a favorable judgment in the trial court, that doesn't mean the defendant will pay up. A years-long appeals process could lie ahead. And even if you win on appeal and get a final judgment, enforcement can be tricky, especially if the defendant has used the delay of litigation to hide its assets.

> *Litigation finance allows a third-party investor—the funder—to bear some or all of the cost (and risk) of litigation, in exchange for a share of case proceeds. Claimholders who yesterday might have been forced to abandon their meritorious claims can now pursue them with their top-choice counsel.*

We see an increasing number of requests for litigation funding in cases that are on appeal or at the asset enforcement stage. We typically think of these cases as monetization investments: we'll give the claimant some percentage of the judgment (usually about 20% to 25%) in exchange for a portion of the case proceeds if the appeal resolves favorably and the plaintiff is able to collect. This helps the claimant mitigate three risks: the *merits risks* they face on appeal; the *timing risk* associated with the uncertainty about when they will ultimately get a final judgment; and the *collection risk* associated with uncertainty regarding whether they can collect against the defendant. Some people think of these transactions as akin to a "collar" strategy which protects the client against the risk of total loss by locking in some gains in return for sacrificing some upside in the case.

Benefits for Large Companies

Appeals funding and asset monetization also point to the emerging trend suggested above, which is that more sophisticated companies that can otherwise afford to pay for the fees and costs of litigation are seeing the value of litigation finance as a tool for risk management. Companies are realizing that they can monetize a legal judgment today, investing the money in their core business rather than having to wait years while the legal process runs its course and the defendant finally pays.

General counsels and chief financial officers are also seeing the value of litigation finance as a way to transform the general counsel's office from cost center to profit center. Legal costs are usually treated as an expense, hurting a company's EBITDA, while any case proceeds are recognized as a one-time financial benefit. Funding allows a company to reduce those legal costs to near zero, while any working capital paid to the company could be recorded as a recurring source of revenue.

Law Firm Portfolios

Funding isn't just for claimholders—it's for law firms, too. Commercial litigation funders also provide capital directly to law firms backed by the firm's contingent interest in a portfolio of matters. The funder's return is typically cross-collateralized against the entire suite of cases in the portfolio. As with single-case funding, law firm funding is non-recourse to the other firm's assets, and it doesn't require the partners to sign personal guarantees either.

Law firms are attracted to portfolios for a few additional reasons. First, many funders don't require the law firm to earmark their capital for use solely on the specific cases that comprise the portfolio. In other words, law firms can use this money to hire new attorneys, expand into new geographic areas, or strategically grow their practices. Litigation funding gives law firms the same access to growth capital that ordinary businesses use all the time.

Second, law firm portfolios typically present less investment risk for the funder than single-case investments, since the funder's investment is, as noted, cross-collateralized against the entire portfolio of matters. Some funders provide a more favorable return structure for portfolios than for single-case funding.

Third, law firm portfolios allow a funder to commit capital not only for the firm's existing cases but also for new cases that might come in the door. If a new client asks a law firm to take a case on a contingency, the firm can accommodate the client through its existing portfolio structure. The funder and law firm will evaluate the case together, and if the case is strong, it can simply be rolled into the existing portfolio, meeting the client's needs and allowing the law firm to take on the new matter.

The Ethics of Litigation Funding

As you might imagine given the rapid growth of litigation finance over the past decade, commercial litigation funding is permitted in the major commercial centers of the United States, and litigation funding need not clash with lawyers' ethical duties to their clients. Indeed, we believe litigation finance affirmatively *promotes* the spirit and purpose of the ethics laws, because it is a powerful tool that allows litigants to achieve their legal objectives even if they lack the ability to pay for top-flight counsel.

Here we will discuss three of the main ethical or legal issues that arise with respect to litigation finance: champerty, fee sharing, and disclosure.

> *[M]ore sophisticated companies that can otherwise afford to pay for the fees and costs of litigation are seeing the value of litigation finance as a tool for risk management.*

The Ancient Doctrine of Champerty

The dusty doctrine of champerty prohibits what William Blackstone termed "officious intermeddling in a suit that no way belongs to one, by maintaining or assisting either party, with money or otherwise," in return for a portion of case proceeds.[1] "The consistent trend across the country," a federal appeals court has acknowledged, "is toward limiting, not expanding, champerty's reach."[2] While litigants and funders should carefully study the relevant law, champerty should not prohibit most commercial litigation finance agreements in most jurisdictions, including in New York.

New York permits standard commercial litigation funding agreements, at least as long as those agreements are for an amount in excess of $500,000. A New York statue prohibits individuals or corporations from taking an assignment of a security "with the intent and for the purpose of bringing an action thereon."[3] Even assuming commercial litigation finance agreements fall within that prohibition, the statute expressly excludes any purchase "having an aggregate purchase price of at least five hundred thousand dollars." *Id.* § 489(2). The New York Court of Appeals affirmed the existence and vitality of this safe harbor in a 2016 decision, *Justinian Capital SPC v. WestLB AG*.[4]

A number of other states, like Massachusetts and South Carolina, have entirely abolished champerty.[5] Other states prohibit champerty only when someone "officiously intermeddles" in someone else's litigation to control and gin up frivolous litigation—but the decisions recognize that reputable funders are not officious intermeddlers.[6] Thus even in states that historically prohibit champerty but have not applied those prohibitions to modern commercial litigation funding, litigation finance should be permitted.

Claimholders and lawyers should always consider the applicable state's champerty regulations. In most jurisdictions, however, champerty should not prohibit litigants or law firms from entering into litigation finance agreements.

Funding and the Rule Against Fee Sharing

Rule 5.4 of the New York Rules of Professional Conduct that govern the legal profession provides that lawyers generally "shall not share legal fees with a non-lawyer . . . ."[7] As noted above, most funding agreements are contracts directly between a funder and a *claimholder*, so the rule against fee sharing is not implicated in those instances. What about funding agreements between a funder and *law firm*?

Major commercial litigation finance companies have done portfolio funding agreements with many of the largest and most reputable law firms in the nation. These law firms and their general counsels have reached the consensus view that the prohibition against fee sharing simply does not prohibit law firm funding agreements, the same way it does not prohibit law firms from obtaining lines of credit or other forms of commonplace financing.

Indeed, at least two New York courts have held that litigation funding agreements did not violate Rule 5.4's prohibition against fee sharing.[8] Those cases even endorsed litigation finance by emphasizing that "litigation funding allows lawsuits to be decided on their merits, and not based on which party has deeper pockets or stronger appetite for protracted litigation."[9]

Nevertheless, in July 2018, the New York City Bar Association's Professional Ethics Committee issued Formal Opinion 2018-5, which concluded that lawyers may not enter into financing agreements where "the lawyer's future payments to the funder are contingent on the lawyer's receipt of legal fees or on the amount of legal fees received in one or more specific matters."[10]

Although the Committee's opinion was non-binding, its advisory conclusion caused a stir. Within months, the New York City Bar Association convened a working group to evaluate litigation funding. The working group unanimously concluded that Rule 5.4 should be amended to expressly permit litigation funding transactions between law firms and funders, both "to reflect contemporary commercial and professional needs and realities," and because "lawyers and the clients they serve will benefit" from lawyers' expanded access to funding.[11] (The working group further emphasized that by proposing revisions to Rule 5.4, it was not confirming or conceding that the rule as currently drafted outlaws any existing funding agreements.)[12]

The working group thus concluded that litigation finance is a *good thing* for our legal system. Crucially, the working group pointed out that there are many other ethics rules, including rules barring conflicts of interest and protecting client confidentiality, that already require lawyers to maintain their independence and place their client's interests above those of a funder.[13]

Disclosure of Funding Documents

Another issue that sometimes arises is whether litigation finance documents and communications are discoverable during litigation. A number of courts have weighed in on this issue over the past several years, and the overwhelming majority of courts, including in New York, have concluded that such documents should not be disclosed to defendants during litigation.

Courts typically refuse discovery requests into funding agreements on one of two grounds. First, many courts conclude that funding documents are simply not *relevant* to the case, and thus are outside the scope of discoverable subject matter. Second, many courts have also concluded that even if funding documents are relevant, they are protected from disclosure by the work product doctrine.

The New York City Bar Association working group on litigation funding waded into the disclosure debate by endorsing the majority view among courts. After comprehensively reviewing the arguments in favor of mandatory disclosure of funding agreements in federal and state court litigation, the working group concluded that mandatory disclosure should not be required.[14] The working group also found that disclosure should not be permitted on a case-by-case basis absent "special circumstances."[15]

One important practice tip: you should enter into a non-disclosure with the funder before providing any confidential information. Courts sometimes look to whether the parties had an NDA in place as a factor in determining whether the work product protection applies.

Benitez v. Lopez

One leading recent decision denying discovery into funding agreements was issued in *Benitez v. Lopez*, a decision out of the Eastern District of New York.[16] The court held that the plaintiff's funding agreements were not discoverable under Federal Rule of Civil Procedure 26(b)(1) because they were not relevant to the case. "[W]hether plaintiff is funding this litigation through savings, insurance proceeds, a kickstarter campaign, or contributions from the union," the court concluded, "is not relevant to any claim or defense at issue."[17]

The defendant speculated that discovery was necessary because there may have been infirm "motives for Plaintiff's suit and for the litigation funding," but the court rejected that argument, emphasizing that "there is no allegation, let alone evidence, that monies from litigation funders were funneled to witnesses as payoffs or that there was some impropriety in the litigation financing. To seek those documents in the hope that similar evidence would materialize in this case is not permissible . . . ."[18]

Conclusion

The New York City Bar Association's working group on litigation finance recently concluded that "lawyers and the clients they serve will benefit" from litigation funding. The significant demand for litigation finance by claimholders and lawyers proves the tremendous value of having a third-party funder bear some of the risks of litigation. Standard commercial litigation funding agreements are consistent with the legal and ethical rules governing the legal profession in New York. Indeed, particularly where claimholders might otherwise be forced to abandon their legal claims but for third-party funding, litigation finance affirmatively promotes the purpose of our legal system: to help claimholders access justice and vindicate their legal rights.

Endnotes

1. 4 W. Blackstone, Commentaries *134–36. *See also In re Primus*, 436 U.S. 412, 424 n.15 (1978).
2. *Del Webb Communities, Inc. v. Partington*, 652 F.3d 1145, 1156 (9th Cir. 2011).
3. New York Judiciary Law § 489(1).
4. 65 N.E.3d 1253, 1257 (N.Y. 2016). The *Justinian* court invalidated the agreement at issue in that case, which was quite different from traditional commercial funding agreements—the funder invested less than the $500,000 floor and took over the claim and sued in its own name. But the Court added: "We emphasize that we find no problem with parties structuring their agreements to meet the safe harbor's requirements, so long as the $500,000 threshold is met, as set forth above." *Id.* at 1258.
5. *Saladini v. Righellis*, 687 N.E.2d 1224, 1226 (Mass. 1997); *Osprey, Inc. v. Cabana Ltd. P'ship*, 532 S.E.2d 269, 277 (S.C. 2000).
6. *See, e.g.*, *Charge Injection Techs., Inc. v. E.I. Dupont De Nemours & Co.*, 2016 WL 937400, at *3–5 (Del. Super. Ct. Mar. 9, 2016); *Odell v. Legal Bucks, LLC*, 665 S.E.2d 767, 775 (N.C. Ct. App. 2008); *Kraft v. Mason*, 668 So.2d 679, 683 (Fla. Dist. Ct. App. 1996).
7. N.Y. R. Prof. Conduct 5.4(a).
8. *Hamilton Capital VII LLC vs Khamani*, 22 N.Y.S.3d 137, 48 Misc.3d 1223(A), at *7–8 (N.Y. Sup. Ct. 2015); *Lawsuit Funding LLC v. Lessoff,* 2013 WL 6409971, at *5–6 (N.Y. Sup. Ct. Dec. 4, 2013).
9. *Lawsuit Funding,* 2013 WL 6409971, at *6; *see also Hamilton Capital*, 48 Misc.3d 1223(A), at *8 (quoting this passage from *Lawsuit Lending*).
10. N.Y.C. Bar, *Formal Opinion 2018-5: Litigation Funders' Contingent Interest in Legal Fees* (July 30, 2018), https://bit.ly/3dmkugP.
11. N.Y.C. Bar, Report to the President By the New York City Bar Association Working Group on Litigation Funding at 23 (Feb. 28, 2020), https://bit.ly/3cmxkKT.
12. *Id.* at 26, 30.
13. *Id.* at 24, 29. The working group divided in two over precisely how Rule 5.4 should be amended, but as noted, both proposals endorsed expressly permitted funding agreements. The proposals differed primarily on whether funding could be used for general firm purposes or only on a particular funded case, the extent of the funder's participation in the case, and whether clients must provide written informed consent. *Id.* at 32–33.
14. *Id.* at 72.
15. *Id.* The committee withheld comment on whether disclosure is appropriate in the class action context, and it recommended routine disclosure of only the fact of funding and the identity of the funder in arbitrations, as opposed to court proceedings. *Id.* at 72–73.
16. 2019 WL 1578167 (E.D.N.Y. Mar. 14, 2019) (Magistrate Judge Bulsara).
17. *Id.* at *1 (quoting *Yousefi v. Delta Elec. Motors, Inc.*, 2015 WL 11217257, at *2 (W.D. Wash. May 11, 2015)).
18. *Benitez*, 2019 WL 1578167, at *2.

Reprinted with permission from: *International Law Practicum*, 2020, Vol. 33, No. 1 published by the New York State Bar Association, One Elk Street, Albany, NY 12207.